

# The Impact of the Economic Downturn on Local Government: What Can We do About It?

Country report: Estonia

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## Overview of Local Governments

In Estonia there is a single-tier local government. There is a central government and 226 municipalities. On the mid-level government there are 15 counties, which are not part of the local, but the central government. Counties are in the administrative field of Ministry of the Interior, but they also advise local governments. On the mid-level there are also various Associations of Local Governments, which are voluntary unions of local governments within each county. 33 of the municipalities are urban municipalities (cities) and 193 are rural municipalities (parishes). Municipalities are ranging in size from Tallinn (capital city) with over 400 000 inhabitants to Ruhnu (a small island) with as few as 60. Estonian municipalities are comparatively small and 81% of municipalities have less than 5 000 inhabitants and only in less than one tenth (8%) there are more than 10 000 inhabitants.

The structure and role of Estonian local governments has been unchanged to a large extent since last major reforms in 1990-1995, after regaining independence from the Soviet Union. Since then a few dissolutions or mergers of LGUs have taken place.

The main revenue sources for local governments are taxes, equalisation transfers and earmarked transfers from the central government. The main areas of expenditures by local governments are education, social care, economic activities, and public administration. (See the following table.)

**Table 1. Main revenues and expenditures by local governments**

| Main revenues  | Main expenditures   |
|--|---|
| 1. Taxes   | 1. Education (includes also children day care) - about 40% of expenditures in 2008; part of the funds come directly from the central government as earmarked transfers, |
| a) personal income tax (part of the personal income tax is transferred to the local municipality where a person lives) – about 50% of aggregate revenues in 2008 | 2. Economic activities (e.g. investments) – about 20% in 2008.  |
| b) land tax (about 3%)   | 3. Social care (subsistence benefits, long term care, health costs of uninsured) – about 7%, money for subsistence benefits comes from the central government,          |
| c) natural resource tax (about 1%)   | 4. Recreation, sport and culture (14%)  |
| d) other local taxes (about 1%)  | 5. Public administration (13%)  |
| 2. Revenue from sales of property (about 1%)   | 6. Environmental protection (4%)  |
| 3. Revenue from providing services and selling goods (about 11%)   |   |
| 4. Equalisation fund (about 6%) (unconditional grant)  |   |
| 5. Earmarked grants from the central government (about 17%) (subsistence benefits, various other benefits)   |   |
| 6. Other earmarked transfers (e.g. investments) (about 9%)   |   |

# 1. Revenues and Expenditures Assignment

## *1.1. Have there been any changes in response to the economic downturn in:*

- *The assignment of local government revenues and expenditures?*
- *The allocation of intergovernmental transfers?*
- *The authority of LGUs over levy of taxes and charges?*

There have been some minor changes in the assignments and some allocation changes.

There were signs of economic downturn in Estonia in 2007 (decelerating GDP growth, rising jobless rate). Local governments have the right to set the rates of land tax. Some LGUs have increased the rates. The aggregate revenues from land tax increased in 2008 compared to 2007 36,7% in nominal terms. The share of land tax in LGU revenues is still modest, around 3%. The capital city, Tallinn, raised the minimum threshold for land tax payment in 2010, which relieves some of the tax burden imposed in 2008. Some at least temporary changes are expected in 2011, when there is a general land revaluation, which should alter the land tax base.

Some local governments (namely the capital city, Tallinn) have started to collect some additional local taxes (sales tax, boat tax). This was done with questionable efficiency, resulting in only little extra budget revenue. Currently, the governing coalition is making law changes to abolish these taxes from the beginning of 2011. The given justification is that the effects of these taxes are not strictly local.

The personal income tax rates are set by the central government, but the revenues are divided between central and local budgets. In 2007 and 2008 LGUs received 11,9% of personal taxable income (and the central government received the rest of the tax revenues, all tax allowances and – subsidies also come from the state budget); in 2009 it was initially increased to 11,93, but since 1 April 2009 it was decreased again to 11,4%, to improve the solvency of treasury. It follows that the LGUs received actually less revenues from personal income tax in relative terms compared to 2008.

In 2009 the state government reduced intergovernmental transfers by EEK 600 million (EUR 38 million). The cuts were partly related to the state funded programmes, which were closed and state budget allocation which were given in rapid growth periods to strengthen LG budgets. There is a foreseen temporary measure in the state budget to counteract revenue decreases and insolvency problems for LG-s.

Decrease in funds has influenced local governments' financial situation which is characterized by the deterioration of short-term solvency. As at the end of 2009, in the light of the aggregate indicators for all local governments, current assets were not sufficient in covering short-term commitments. Analysis of local governments' management costs and outstanding debts to suppliers indicate extended deadlines for paying debts. Compared to the previous year, the percentage of loans in rural municipalities' and cities' balance sheets increased by 1% in 2009 (in 2008, the yearly increase was 4%). At the same time the number of local governments whose burden of loan has exceeded the limit prescribed by law, or is about to exceed that limit, is growing. (National Audit... 2010)

Of different types of expenses, management expenses decreased the most (18%) and expenditure on investments (29%) in 2009. At the same time, expenses related to local governments' personnel decreased only by 3%, compared to 2008. By areas, most funds have been saved on the maintenance

of local roads, but significant amounts have also been saved on financing culture and sports, education and local government administration. Most rural municipalities and cities (72%) have managed to cut their expenses when the revenue decreases, but many (37%) have failed to do so equivalently to the decrease in expenses. However, despite the decrease in revenue, some (11%) have managed to increase their expenditure. (National Audit... 2010)

***1.2. How far are efforts to concentrate shrinking financial resources on maintaining essential public services undermined by expenditure norms or service standards which are unsustainable in current economic circumstances? Are any measures to relax such requirements in progress?***

Concerning everyday public services, there has not been any direct changes. Some LGUs have tried to improve the cost-efficiency of everyday social services, e.g. merging child day-care units.

Most LGUs have cut down or postponed expenditures on investments into buildings, and infrastructure for 2009-2010 (unless funded by EU structural funds).

Minister responsible for regional affairs has initiated activities to relieve some unnecessarily high service standards or requirements which are too burdensome in current economic circumstances, but only little action has followed (eg the reconsidering of the healthcare conditions of kindergartens by the Ministry of Social Affairs)

***1.3. Changes in cooperation between national and local governments:***

- How did the economic downturn influence the formulation of local budgets, especially in the case of the 2010 budget preparation? Were there any major changes in the stages of planning, the actors involved, in the information collection techniques, in the planning and reporting methods?
- How did the usual forms of dialogue and negotiations between the national and the local governments alter in the period of economic downturn?
- Were the local governments properly informed about the objectives and the policy instruments designed by the national governments to cope with the consequences of the economic crisis?

Ministry of Finance steadily monitors LG-s financial situation. LG-s in financial risk have been asked to prepare 4 year budgets plans to ensure better fiscal performance and for avoiding financial difficulties.

The temporary measure to stabilise revenue decreases and to fund LG-s insolvency solutions from the state budget was introduced to Local Government Cooperation Assembly in 2009. In the process of budgetary negotiations between LGCA and the state (Government Commission), the specific annual division of these resources is also presented to LG-s before adapting.

## **2. Improved Administrative and Service Efficiency**

***2.1. What measures have been implemented or considered to improve the efficiency of local government expenditure? To what extent have they used performance audit, benchmarking or other processes with similar aims?***

None. Each LG unit has to find out its solution to increase efficiency.

***2.2. Has outsourcing public service delivery increased in response to the crisis, and, if so, with what impact on cost and quality?***

Minister for Regional Affairs has initiated the preparation of the concept of contracting out local public services which will be presented to the state government in July 2010. The initiative has not directly driven from the recession, but one of the aims of enhancing contracting out local public services is to increase efficiency of service delivery.

***2.3. How far have measures been considered or implemented to reduce the costs of local administrative structures or increase economies of scale by increasing inter-municipal co-operation? Has there been any attempt to reduce overheads by horizontal collaboration with other public agencies at local level such as de-concentrated government offices?***

No specific measures have been taken, but local governments are and have always been encouraged to co-operate by the central government.

There are some pilot studies, funded by EU structural funds or EEA and Norwegian Financial Mechanism, where LGUs have started co-operation in provision of social services or transport services. This process has required also audits and standardisation of current services. In the medium-run it may help to increase cost-efficiency of service provision.

***2.4. Is there any plan to consolidate (small) local government units or to reallocate service functions between tiers of local government?***

The administrative reform for consolidation has been in the agenda for several years (at least since the beginning of the last decade). All political parties, social partners, and experts are continuously stressing the need for administrative reform, which would include consolidation of LGUs, but so far no political agreement has been reached how to exactly implement this reform. Current economic crisis has put renewed pressure on the reform plans. In March 2009 current minister responsible for Regional Affairs has proposed a new plan for consolidation of LGUs, but this was rejected again by the coalition parties. The Minister continues to find support and to call for the administrative reform in almost every public statement.

There is a state financial incentive to support voluntary local government amalgamations. Nevertheless, in the last four years, only one voluntary merger has taken place - two rural municipalities have taken the final steps in order to join in the immediate future. Their combined population is just over 3000 people, with the smaller of the two having around 500 people. This voluntary merger was praised by the minister, as a bold example of what most of these small municipalities with low administrative performance and investment capabilities should do. (Eesti Siseministeerium (1) 2009)

In March 2010, The Supreme Court gave a devastating assessment to the financing of local governments. Especially, they pointed out, that the state financing of central services which are administered by LG's is not distinguishable from the state financing for local services. In general, The Supreme Court stated, that the connexity principle (the changes in the allocation of services must be

met by the equivalent allocation of revenues) does not fully apply in Estonia. The consequences of this are still to follow. Some fundamental law changes are expected.

### **3. Stimulating Local Capital Investments**

***3.1. Is any extra funding being made available to enable local governments to undertake investment projects with countercyclical effects? Are local governments well prepared to take advantage of it? Or on the contrary, has fiscal austerity reduced funds allotted to sub-national capital investments; if so, in what way and to what extent?***

Economical downturn has not influenced the total amount of EU funds allocated to LG-s. State budget funds for LG-s investments were the subject of expenditure cuts.

The measure „Strengthening of the Competitiveness of Regions“, which is a measure of European Regional Development Fund for LG’s to enhance their attractiveness to visitors, tourists and entrepreneurs, stopped accepting applications in January 2009. Accepting applications was partly resumed in Fall 2009 and in Spring 2010. Since this fund was established before the economic downturn (2007), it is aimed at entrepreneurship and will continue payments at least until 2013, it can be considered, with reservations, an extra funding for local investments with countercyclical effects.

LGU’s are well prepared to take advantage of it, since only 15% own funding is required and almost every project, which enhances the competitive performance of a municipality, is applicable.

Another form of extra funding made available in December 2008, The Measure „Development of Urban Regions“ (about 0,2% of GDP), of The European Regional Development Fund. The six largest cities were applicable, mainly the projects consist of the reconstruction of public areas, kindergartens etc. Since the Estonian construction sector was the most severely hit by the economic downturn, the countercyclical effects of these projects are most welcome. (Eesti Siseministerium (3) 2008)

Additional 0,4% of GDP was made available in March 2009 for seven cultural and tourism projects, also financed by The European Regional Development Fund. Since these projects are large-scale construction or reconstruction projects, the countercyclical effects are present. (Eesti Siseministerium (4) 2009)

Concerning investments, the local government investment support program (so-called KOIT) is taking applications since February 2009. It is aimed at essential public services like schooling, children day-care and social welfare centres. The program helps stabilise service providing, but no specific measures for concentrating financial resources have been taken. It is, however, relaxing these requirements on local governments, since the funding comes from The European Regional Fund. (Eesti Siseministerium(5) 2009)

***3.2. To what extent have local investments and service improvements aimed specifically to:***

- ***Repair damage to local economies and employment levels;***
- ***Combat environmental degradation and climate change;***
- ***Extend local infrastructure and increase its efficiency.***

In the framework of allocation of EU funds LG-s have the possibility to apply funds for projects related to decreasing unemployment. LG infrastructure is subject to funds gained from sale of CO2 quotas.

**3.3. How far have the following measures been taken to enhance municipal investments? Which are most preferred?**

**3.3.1. Increasing access to external sources:**

- **improving local awareness of EU structural and pre-accession funds; easing project requirements, increasing EU co-funding shares;**
- **special national funding schemes and public investments programs focus on local governments;**
- **enhancing local borrowing: e.g. through interest rate and lending policy; special subsidised credit lines; restructuring municipal borrowing (from loans to bonds); issuing local government guarantees; easing national control over local borrowing decisions; transparent regulations on local debt and insolvency; special measures for debt recovery, support to smooth cash flow**
- **development of public-private partnerships: are they in decline; have there been delays or cancelations of PPP projects; how stable is the revenue stream for PPP projects?**

Law changes have been made to ease both project requirements and co-funding share of EU structural funds. Project requirements were eased by increasing the bridge financing (e.g. flexible payments) of the beneficiary. Also the project application dates are being brought closer, so that more funds can be applied for earlier. Local awareness is high enough, some projects have already been turned down due to insufficient funds (see 3.1.). PPP projects are not significantly used in Estonia.

Local borrowing has certain limitations – every financial obligation has to stand up to certain criteria and be approved by the ministry of finance. These limitations were introduced 1 March 2009 and will stand until the end of 2011. LGU's can take financial obligations (loans, selling bonds etc) on two conditions: for co-financing investments made with funds from EU structural funds or other outside funds and also for financing obligations taken before the introduction before the limitations were introduced. (Rahandusministeerium 2009).

State government has borrowed funds from EIB for environmental infrastructure projects. These funds are available for LG-s as loans with beneficial interest rate and re-payment conditions.

**3.3.2. Improving project preparation and management: developing a bank of small scale infrastructural construction and repair projects which might qualify for fiscal stimulus funding.**

Project repairing was used for the projects concerning The measure of Development of Urban Regions described in 3.1. However, no significant measures have been taken to improve project preparation and management on a larger scale.

**3.4. Promoting indirect measures for improving local investments**

- **Business promotion, attracting/keeping inward investments**
- **SME development**

- **Better targeting regulations**
- **Devolution of public property, improved asset management, land development policies**

The measure „Strengthening of the Competitiveness of Regions“ (described in 3.1.) promotes local economic development. This funds projects that enhance the local entrepreneurial environment. And another measure develops regional competency centres outside the two richest counties.

**3.5. Benefitting from national economic stimulus programmes designed for local governments in improving energy efficiency and using environmentally-friendly solutions. Local actions in urban transportation, improving facility management of local service organisations, employment, urban planning, etc.**

LG-s have free access to EU funds (ERDF) focused on improving energy efficiency and using environmentally friendly solutions (improving transport, public areas etc). Funds gained from the sale of CO2 quotas are available for the development of environmentally friendly urban transport

## **4. Targeting Social Expenditures**

**4.1. Have any measures been taken or proposed to local governments for reducing the costs of social expenditures by modifying the system of social benefits or services?**

For LG-s financial recovery process state government has the criteria that social services and benefits should be re-shaped and targeted especially to poorest households. No general rule has been enforced.

**4.2. Is the cost to local government of social benefits and services rising as a result of the economic downturn? Which of such cost increases has been the most prominent?**

Local governments provide social benefits using mostly earmarked funding from the state budget. Hence, no direct increase in social costs for local governments. For example, the cost of subsistence benefits (means-tested social assistance benefits that partly cover also housing costs) has increased manifolds, but these expenditures are funded from the central budget.

On the other hand, several municipalities have increased the provision of social services, such as introduction of social work and free meals. For example, Tallinn, the capital city, has considerably extended social work programme as a response to increased unemployment. In 2009 they introduced several hundred social workplaces. (Source: City of Tallinn, [www.tallinnaitab.ee](http://www.tallinnaitab.ee))

Also the provision of free meals has increased and been extended in Tallinn and some other larger cities (e.g. Narva). Smaller municipalities have fewer resources to provide additional services in addition to subsistence benefits.

**4.3. Have any policies been put in place in response to the crisis to improve the targeting of social assistance to the needs of the poorest and most affected households?**

Yes. Increased expenditures on the creation of social workplaces, or soup kitchens are targeted to the very poorest households.

***4.4. What measures have been taken to alleviate possible legal and procedural obstacles to access to social assistance by low income households?***

There are no formal obstacles. Subsistence benefit scheme is a means-tested benefit guaranteeing a minimum income to all residents. Households whose income, whether from labour earnings, unemployment benefits, pensions, etc., after payment for housing expenses, calculated according to certain criteria, is below the subsistence level are entitled to these benefits.

Households need to submit information on their income and housing expenditures every month. Local municipalities who pay out the social assistance benefits have the right to refuse the payment of benefits to people in working age and capable for work, but who do not study or work, and who have repeatedly, without good reason, refused to accept suitable work.

***4.5. Is any encouragement being given to increasing the role of voluntary and community care to lessen costs of local government provision for social services?***

No formal encouragement. But, the concept of contracting out (in 2.2) is also aimed at encouraging provision of local government services by third sector service providers, as the social services are one of areas mainly contracted out to third sector by LG-s.

## **5. Local Government Action and Innovation**

***5.1. Did the local government assume the role of an anti-crisis actor through its own fiscal, social or other policies; to what extent did it become a "part of the solution"?***

The fiscal autonomy of Estonian local governments is rather limited. They have little possibility of expanding their revenue base to implement extra policies. However, they are a part of the economy and the public sector, thus must take the role of solving the problems caused by the crisis. A few of the larger local governments have introduced social work programs, but the impact of this is rather small.

***5.2. Have innovative policies been designed or implemented at the local level to address the consequences of the fiscal, economic and social crisis?***

There are some single project-based activities financed from the EEA and Norwegian financial mechanism to support regional development (e.g Activation Centre for Unemployed in Jõgeva County etc). Other than that, there have been no formal relevant innovative policies designed or implemented by local governments.

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